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ECONOMY

Illustration: Emilio Rivera

ANALYSIS

## It is time to worry about inflation not deflation

**Recent abuses of monetary policy may condemn those who cannot remember the past to repeat it**

Richard Harris

Hong Kong's inflation ran at double digits from 1989 to 1995, often remarkably near the 9.9 per cent level. The maths may have been correct – but what was being measured? The man in the street considered inflation to be closer to 25 per cent than 10 per cent. The issue is how is inflation measured, and by whom is it so imperfectly calculated, especially as it discounts many key economic statistics.

The BBC estimates Venezuelan inflation to be over 300 per cent this year; the International Monetary Fund says 51 per cent – a significant disparity. As inflation rises, numbers are quoted "less housing" or "less oil". It took decades for the cost of vinyl records or coal to come out of the consumer price index. The Europeans are adding the economic value of prostitution and illegal drug trading into their GDP and no doubt the measurement of those will require new analytical tools.

Inflation is one unpleasant economic consequence that we think we have beaten. Growth and unemployment are the big issues now – and avoiding at all costs the 20-year death spiral of slow growth, low inflation Japan. Inflation is now needed to erode government debt, to keep happy salarymen and public servants on inflation-linked incomes, and generally to make people feel better.

In the high inflation of the 1990s, Hong Kong employees of big organisations often had annual inflation adjustments of 15 per cent. If you were able to save money, your savings would grow at that rate per year, which you could invest into an inflation-proofed real asset, at a mortgage rate over 20 per cent. Inflation's losers are the lower and middle classes who can't earn enough to make ends meet.

Six years ago, the cleverest economic brains in the world included those in the Bundesbank, who frequently warned of Germany's 1922 hyperinflation. In Zimbabwe, the annual inflation rate was 80 billion per cent in November 2008; and I have several One Hundred Trillion Zimbabwe Dollar notes to prove it. Naturally, printing money is not something major central banks would consider today; creating US$3 trillion of liquidity through US Federal Reserve bond purchases is much more suitable for the digital age.

The new generation of silver-haired central bankers cannot remember hyperinflation and were protected salarymen during the high inflation from the '70s to the '90s. They see inflation coupled to economic growth – and deflation coupled to Japan and its comatose economy. US growth today is better than the 15-year average but there is not enough to bail governments out of their debt trap. Those same policymakers are therefore terrified of deflation and in Europe, there is enough panic to experiment with negative interest rates.

> **Trying to create growth by targeting inflation is putting the cart before the horse**

In fact, if the cleverest brains in the world took a moment to stop to think, they would understand that inflation is a resultant – not a cause. Inflation results from growth; it doesn't cause it. So trying to create growth by targeting inflation is putting the cart before the horse. It is not the job of the central bankers to create economic growth, anyway. The main responsibility lies with governments who have largely done nothing since 2008.

Deflation in its mild form is no worse than inflation in a mild form. From 1999 to 2005, according to the IMF, Hong Kong suffered an average annual deflation of 2.1 per cent. Japan (the place to avoid, remember) suffered deflation of just 0.5 per cent. Over the 17 years since the Asian financial crisis, Hong Kong had average annual inflation of just 1.1 per cent per annum, while in Japan prices have stayed dead flat.

In that time, Hong Kong has grown 3.5 per cent a year, Japan less than 1 per cent and the US, 2.41 per cent (on 2.36 per cent inflation). For many reasons, this is not a rigorous comparison but should alert policymakers to decouple growth and inflation as policy aims – and not be deflation-phobic.

It also troubles central bankers and analysts that their mathematical models stop working at zero interest rates. Perhaps it is time to derive a new set of models. Swire Pacific and Cheung Kong survived the economics of two consecutive years of 4 per cent deflation around the millennium, so there must be a model that can show that.

Even though it is clear that we don't really understand inflation and its partner deflation, we do know that economics comes in cycles. We should not be worrying about deflation but about inflation. We have abused monetary policy too much recently for inflation not to return as soon as the consumer has some cash in his pocket.

It was said at the D-Day remembrance that Britain's Queen Elizabeth is the only head of state who remembers the second world war. Our policymakers have conveniently forgotten history – and those who cannot remember the past are condemned to repeat it.

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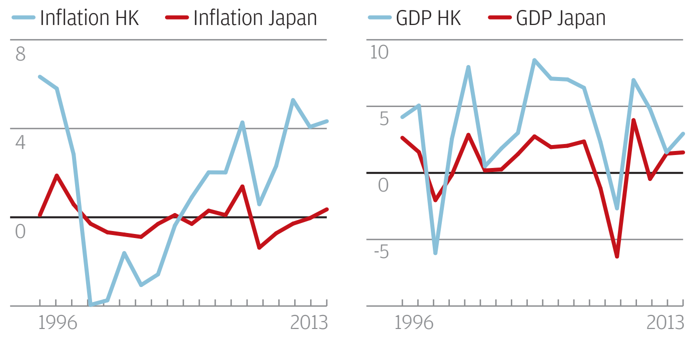
### Crossed lines




Sources: IMF, IndexMundi

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